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From: Precursor Group - Scott Cleland
To: Michael Copps
Date: Tue, Mar 18, 2003 11:45 PM
Subject: How UNE-P Fuels the Fire of Telecom's Competitive Intensity

Federal Communications Commission
Office of the Secretary

Summary: Precursor advises an underweight in telecom services, with a market weight for VZ, in large part because the FCC's reinvigoration of UNE-P along with Bell long distance entry heats up telecom's competitive intensity. Competition in the telecom sector is increasingly characterized by the Bells and long distance (LD) carriers swapping resale revenues at lower profit margins. This "tele-commoditization" dynamic pours fuel on the bonfire of government-orchestrated competition that is already vaporizing profits. Among the local telcos, SBC and BLS are at greatest risk to UNE-P; VZ is best positioned to weather it; and Q is less at risk to UNE-P due to unfavorable economics in its rural footprint, but has broader problems. Precursor believes that Bell '03 and '04 earnings guidance likely does not fully reflect the acceleration of UNE-P, and that the Bells could guide earnings expectations downward in the quarters ahead. UNE-P, net of LD, could put at risk an additional \$600m to \$1.1b in '03 and an additional \$400m to \$1.3b in '04 above and beyond what is likely in Bell forward guidance because the Bells were surprised that the FCC did not phase out UNE-P. Moreover, this is in addition to the profit drain attributable to wireless and data substitution, second line loss, and business line loss. Already-ailing LD carriers (T, FON, and WorldCom) face more destruction from increasing Bell entry into their core markets. UNE-P may slow their decline, but is unlikely to save them. (The full research can be accessed by viewing the attached PDF file.)

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Patrick S. Brogan
Scoff C. Cleland
March 18, 2003

How UNE-P Fuels the Fire of Telecom's Competitive Intensity

(Part Three in a TeleCommoditization Series)

Summary: Precursor advises an underweight in telecom services, with a market weight for VZ, in large part because the FCC's reinvigoration of UNE-P along with Bell long distance entry heats up telecom's competitive intensity. Competition in the telecom sector is increasingly characterized by the Bells and long distance (LD) carriers swapping resale revenues at lower profit margins. This "tele-commoditization" dynamic pours fuel on the bonfire of government-orchestrated competition that is already vaporizing profits. Among the local telcos, SBC and BLS are at greatest risk to UNE-P. VZ is best positioned to weather it, and Q is less at risk to UNE-P due to unfavorable economics in its rural footprint, but has broader problems. Precursor believes that Bell '03 and '04 earnings guidance likely does not fully reflect the acceleration of UNE-P, and that the Bells could guide earnings expectations downward in the quarters ahead. UNE-P, net of LD, could put at risk an additional \$600m to \$1.1b in '03 and an additional \$400m to \$1.3b in '04 above and beyond what is likely in Bell forward guidance because the Bells surprised that the FCC did not phase out UNE-P. is in addition to the profit drain attributable to substitution, second line loss, and business ailing LD carrier SON, (and WorldCom) face more destruction from increasing Bell entry into their core markets. UNE-P may slow their decline, but is unlikely to save them.

UNE-P Has Momentum and Is Poised to Accelerate. UNE-P lines grew 80% in '02 for the Bells, from 5.7m to 10.2m, and now threaten to accelerate even further. It is reasonable to say that UNE-P lines could grow between 50% and 100% in '03 and about half that in '04. We have estimated high and moderate growth scenarios in which UNE-P lines grow to between 15m and 20m in '03, and between 20m and 30m in '04. Compared to a UNE-P phase out, where lines grow to 12m next year and fall to 11m in '04, these estimates show differentials of 3m to 8m lines in '03 and 9m to 19m in '04. In sum, UNE-P has turned from a growing but manageable brushfire into a firestorm that could quickly go out of control for the Bells (especially SBC and BLS) that have a fixed cost base that is hard to cut quickly.

UNE-P is a Profit Killer. Precursor estimates (see attached chart) that the incremental impact on pretax operating profits from UNE-P adds, net of LD profit gains, will be between an additional loss of ~\$600m to \$1b in '03 and an additional loss of ~\$400m to \$1.3b in '04, absent offsetting cost savings or new profit streams. This compares with a net loss of ~\$375m in '03 and a ~\$170m profit gain in '04 due to customer win backs if UNE-P had been phased out as the Bells expected. Bell pretax operating profits were ~\$30b in '02, before backing out

nonrecurring and non-operating items: net income was ~\$12b. To further put this in context, the pretax profit drain attributable to all accumulated UNE-P lines for '04 will likely be between \$3b and \$4.5b, or ~\$2.2b to \$3.5b after netting out projected LD gains. In our projections, nearly all of the UNE-P discount is profit drain to the Bells because there is minimal avoided cost when a Bell loses a UNE-P line, especially in the short-term.

UNE-P Reinforces the Commodity Pricing of Voice Service. Wireline voice telecom is a mature market. Penetration is ~95% and baseline growth is pegged to households (~1% to 2% a year) and businesses, which are tied to a skittish economy. Falling prices would not generate additional demand and would implode revenues. Such mature markets breed intense competition for scarce share of commodity services. UNE-P reinforces the commoditization of telecom by skewing competitive entry toward cheap resale of incumbent facilities and functionalities, with no differentiation. The incentive is to shift carrier spending from capex to price wars, marketing, and customer service.

Moreover, this **LD Entry and UNE-P Drain Profits.** Large fixed costs, both Bells and LD carriers must stem revenue losses in their own markets by scrambling for offsetting revenue in the other's markets. However, due to regulated resale pricing and hyper competition, these revenue swaps will likely crunch margins for both players. The Bells are now approved to offer LD on over three-quarters of their lines (four-fifths including GTE and SNET). About 80% of the RBOC line approvals came last year, meaning the Bells will likely add increasing share in '03. In-region LD lines grew last year by over 40% from 12.3m to 17.5m in '02. We expect to see between 40% and 80% line growth in '03, with a moderate scenario of 50%-60% most likely. But LD profits are meager—it is generally not profitable for Bells for 12-15 months and is about 15% thereafter. At the same time, over half of the states reduced UNE-P rates last year, mostly as a condition to Bell entry, making UNE-P entry even more attractive. About three-quarters of the financial benefit of UNE-P goes to the ailing LD carriers and CLECs, whom it will not likely save in the end. Consumers may gain short-term price reductions, but at the expense of an increasingly unhealthy sector, less technological innovation, and poorer service quality.

UNE-P is Only Half the Problem. UNE-P represents about half the Bells' quarterly line loss, and growing. The other half consists largely of lines dropping off the Bell networks. These may be both primary and second liner lost to wireless, cable telephony, broadbanding, or a faltering economy, and may present an even bigger problem for the Bells. * * * *



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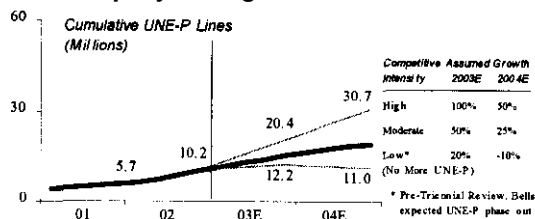
The Precursor Group¹

March 18, 2003

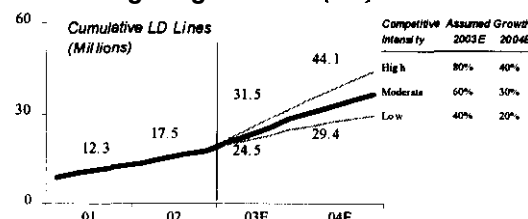
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Reinvigorated UNE-P Raises Competitive Intensity and Erodes Bell Profits

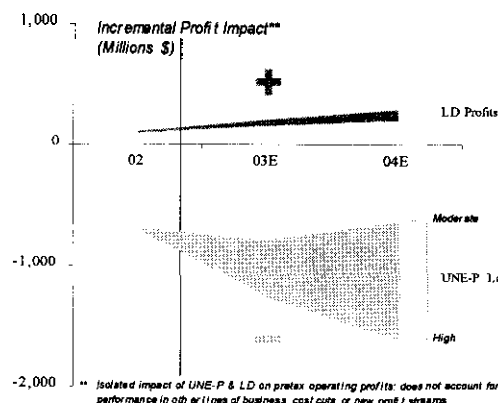
Bells are Rapidly Losing UNE-P Lines...



But Gaining Long Distance (LD) Subscribers

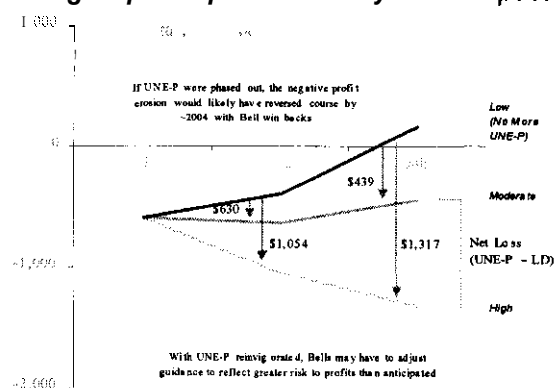


UNE-P Profit Drain Exceeds LD Profit Gain...



Estimate		2003E	2004E
LD Profit Added	High	200	390
	Moderate	160	210
UNE-P Profit Drain	High	-1,250	-1,610
	Moderate	-800	-650
Net Profit Impact	High	-1,050	-1,320
	Moderate	-630	-440

Creating Gap in Expected & Likely Profit Impact



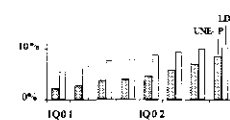
Key Assumptions:

Monthly local phone rates \$20 residential, \$50 business; monthly LD revenue \$10 res., \$40 bus.; UNE-P discount 50%; Profit lost through UNE-P discount 98% (2% avoided cost); (LD is unprofitable for ~12-15 months after entry, 15% thereafter); ideally we would assume ~7.5% in '03 and 15% in '04 - but to smooth the impact we assumed an avg. of 10% in both years. UNE-P res./bus. distribution 60/40 in '02, 65/35 in '03, 70/30 in '04. Bell LD res./bus. distribution 80/20 in '02, 78/22 in '03, 76/24 in '04.

Increasing Competitive "Telecommoditization" Affects Bells Differently

SBC Most At Risk from UNE-P

20% - % of Total Access Lines***

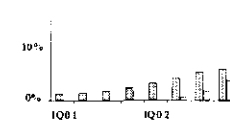


As of 4Q02:

• UNE-P Lines	5.0m
• 2002 UNE-P Growth	109%
• LD Subs	6.1m
• 2003 LD Outlook: High double digit LD growth	
• Wireless Subs (Millions)	13m

BLS UNE-P Risk Rising

20% - % of Total Access Lines***

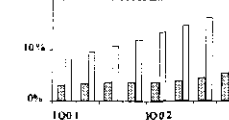


As of 4Q02:

• UNE-P Lines	1.5m
• 2002 UNE-P Growth	157%
• LD Subs	1.9m
• 2003 LD Outlook: 200-300% LD growth	
• Wireless Subs (Millions)	9m

VZ Best Positioned

20% - % of Total Access Lines***

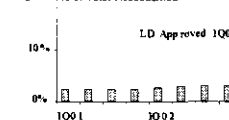


As of 4Q02:

• UNE-P Lines	3.2m
• 2002 UNE-P Growth	43%
• LD Subs	10.4m
• 2003 LD Outlook: Low double digit growth	
• Wireless Subs (Millions)	32m

Q Least Affected****

20% - % of Total Access Lines***



As of 4Q02:

• UNE-P Lines	0.5m
• 2002 UNE-P Growth	8%
• LD Subs	-
• 2003 LD Outlook: ~2m line growth (10-15% of total)	
• Wireless Subs (Millions)	1m

Graphics: Michael Chupeco

Sources: Precursor Analysis, Company Reports, FCC

**** While Q is least vulnerable to UNE-P, Precursor believes it faces broader problems

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